

## Internal Revenue Service, Treasury

## § 1.704-3

when making reverse section 704(c) allocations on or after the date of disqualification.

(viii) *Transitional rule for qualified financial assets revalued after effective date.* A securities partnership revaluing its qualified financial assets pursuant to § 1.704-1(b)(2)(iv)(f) on or after the effective date of this section may use any reasonable approach to coordinate with revaluations that occurred prior to the effective date of this section.

(ix) *Examples.* The following examples illustrate the principles of this paragraph (e)(3).

*Example 1. Operation of the partial netting approach—(i) Facts.* Two regulated investment companies, X and Y, each contribute \$150,000 in cash to form PRS, a partnership that registers as a management company. The partnership agreement provides that book items will be allocated in accordance with the partners' relative book capital accounts, that book capital accounts will be adjusted to reflect daily revaluations of property pursuant to § 1.704-1(b)(2)(iv)(f)(5)(iii), and that reverse section 704(c) allocations will be made using the partial netting approach described in paragraph (e)(3)(iv) of this section. X and Y each have an initial book capital account of \$150,000. In addition, the partnership establishes for each of X and Y a revaluation account with a beginning balance of \$0. On Day 1, PRS buys Stock 1, Stock 2, and Stock 3 for \$100,000 each. On Day 2, Stock 1 increases in value from \$100,000 to \$102,000, Stock 2 increases in value from \$100,000 to \$105,000, and Stock 3 declines in value from \$100,000 to \$98,000. At the end of Day 2, Z, a regulated investment company, joins PRS by contributing \$152,500 in cash for a one-third interest in the partnership [\$152,500 divided by \$300,000 (initial values of stock) + \$5,000 (net gain at end of Day 2) + \$152,500]. PRS uses this cash to purchase Stock 4. PRS establishes a revaluation account for Z with a \$0 beginning balance. As of the close of Day 3, Stock 1 increases in value from \$102,000 to \$105,000, and Stocks 2, 3, and 4 decrease in value from \$105,000 to \$102,000, from \$98,000 to \$96,000, and from \$152,500 to \$151,500, respectively. At the end of Day 3, PRS sells Stocks 2 and 3.

(ii) *Book allocations—Day 2.* At the end of Day 2, PRS revalues the partnership's qualified financial assets and increases X's and Y's book capital accounts by each partner's 50 percent share of the \$5,000 (\$2,000 + \$5,000 - \$2,000) net increase in the value of the partnership's assets during Day 2. PRS increases X's and Y's respective revaluation account balances by \$2,500 each to reflect the amount by which each partner's book capital account increased on Day 2. Z's capital ac-

count is not affected because Z did not join PRS until the end of Day 2. At the beginning of Day 3, the partnership's accounts are as follows:

	Stock 1	Stock 2	Stock 3	Stock 4
Opening Balance	\$100,000	\$100,000	\$100,000	.....
Day 2 Adjustment	2,000	5,000	(2,000)	.....
Total	\$102,000	\$105,000	\$98,000	\$152,500

	X		
	Book	Tax	Revaluation account
Opening Balance	\$150,000	\$150,000	0
Day 2 Adjustment	2,500	0	\$2,500
Closing Balance	\$152,500	\$150,000	\$2,500

	Y		
	Book	Tax	Revaluation account
Opening Balance	\$150,000	\$150,000	0
Day 2 Adjustment	2,500	0	\$2,500
Closing balance	\$152,500	\$150,000	\$2,500

	Z		
	Book	Tax	Revaluation account
Opening Balance	.....	.....	.....
Day 2 Adjustment	.....	.....	.....
Closing Balance	\$152,500	\$152,500	\$0

(iii) *Book and tax allocations—Day 3.* At the end of Day 3, PRS decreases the book capital accounts of X, Y, and Z by \$1,000 to reflect each partner's share of the \$3,000 (\$3,000—\$3,000—\$2,000—\$1,000) net decrease in the value of the partnership's qualified financial assets. PRS also reduces each partner's revaluation account balance by \$1,000. Accordingly, X's and Y's revaluation account balances are reduced to \$1,500 each and Z's revaluation account balance is (\$1,000). PRS then separately allocates the tax gain from the sale of Stock 2 and the tax loss from the sale of Stock 3. The \$2,000 of tax gain recognized on the sale of Stock 2 (\$102,000—\$100,000) is allocated among the partners with positive revaluation account balances in accordance with the relative balances of those revaluation accounts. X's and Y's revaluation accounts have equal positive balances; thus, PRS allocates \$1,000 of the gain from the sale of Stock 2 to X and \$1,000 of that gain to Y. PRS allocates none of the gain from the sale to Z because Z's revaluation account balance is negative. The \$4,000 of tax loss recognized from the sale of Stock

3 (\$96,000—\$100,000) is allocated first to the partners with negative revaluation account balances to the extent of those balances. Because Z is the only partner with a negative revaluation account balance, the tax loss is allocated first to Z to the extent of Z's (\$1,000) balance. The remaining \$3,000 of tax loss is allocated among the partners in accordance with their distributive shares of the loss. Accordingly, PRS allocates \$1,000 of tax loss from the sale of Stock 3 to each of

X and Y. PRS also allocates an additional \$1,000 of the tax loss to Z, so that Z's total share of the tax loss from the sale of Stock 3 is \$2,000. PRS then reduces each partner's revaluation account balance by the amount of any tax gain allocated to that partner and increases each partner's revaluation account balance by the amount of any tax loss allocated to that partner. At the beginning of Day 4, the partnership's accounts are as follows:

	Stock 1	Stock 2	Stock 3	Stock 4
Opening Balance .....	\$100,000	\$100,000	\$100,000	\$152,500
Day 2 Adjustment .....	2,000	5,000	(2,000)	.....
Day 3 Adjustment .....	\$3,000	(3,000)	(2,000)	(1,000)
Total .....	\$105,000	\$102,000	\$96,000	\$151,500

	X and Y		
	Book	Tax	Revaluation account
Opening Balance ...	\$150,000	\$150,000	0
Day 2 Adjustment ..	2,500	0	\$2,500
Day 3 Adjustment ..	(1,000)	0	(\$1,000)
Total .....	\$151,500	\$150,000	\$1,500
Gain from Stock 2	0	\$1,000	(1,000)
Loss from Stock 3	0	(\$1,000)	1,000
Closing Balance .....	\$151,500	\$150,000	\$1,500

	Z		
	Book	Tax	Revaluation account
Opening Balance ...	\$152,500	\$152,500	0
Day 3 Adjustment ..	(1,000)	0	(\$1,000)
Total .....	\$151,500	\$152,500	(\$1,000)
Gain from Stock 2	0	0	0
Loss from Stock 3	0	(2,000)	2,000
Closing Balance .....	\$151,500	\$150,500	\$1,000

**Example 2. Operation of the full netting approach—(i) Facts.** The facts are the same as in Example 1, except that the partnership agreement provides that PRS will make reverse section 704(c) allocations using the full netting approach described in paragraph (e)(3)(v) of this section.

(ii) **Book allocations—Days 2 and 3.** PRS allocates its book gains and losses in the manner described in paragraphs (ii) and (iii) of Example 1 (the partial netting approach). Thus, at the end of Day 2, PRS increases the

book capital accounts of X and Y by \$2,500 to reflect the appreciation in the partnership's assets from the close of Day 1 to the close of Day 2 and records that increase in the revaluation account created for each partner. At the end of Day 3, PRS decreases the book capital accounts of X, Y, and Z by \$1,000 to reflect each partner's share of the decline in value of the partnership's assets from Day 2 to Day 3 and reduces each partner's revaluation account by a corresponding amount.

(iii) **Tax allocations—Day 3.** After making the book adjustments described in the previous paragraph, PRS allocates its net tax gain (or net tax loss) from its sales of qualified financial assets during Day 3. To do so, PRS first determines its net tax gain (or net tax loss) recognized from its sales of qualified financial assets for the day. There is a \$2,000 net tax loss (\$2,000 gain from the sale of Stock 2 less \$4,000 loss from the sale of Stock 3) on the sale of PRS's qualified financial assets. Because Z is the only partner with a negative revaluation account balance, the partnership's net tax loss is allocated first to Z to the extent of Z's (\$1,000) revaluation account balance. The remaining net tax loss is allocated among the partners in accordance with their distributive shares of loss. Thus, PRS allocates \$333.33 of the \$2,000 net tax loss to each of X and Y. PRS also allocates an additional \$333.33 of the net tax loss to Z, so that the total net tax loss allocation to Z is \$1,333.33. PRS then increases each partner's revaluation account balance by the amount of net tax loss allocated to that partner. At the beginning of Day 4, the partnership's accounts are as follows:

	Stock 1	Stock 2	Stock 3	Stock 4
Opening Balance .....	\$100,000	\$100,000	\$100,000	\$152,500
Day 2 Adjustment .....	2,000	5,000	(2,000)	.....
Day 3 Adjustment .....	3,000	(3,000)	(2,000)	(\$1,000)
Total .....	\$105,000	\$102,000	\$96,000	\$151,500

	X and Y		
	Book	Tax	Revaluation account
Opening Balance ...	\$150,000	\$150,000	0
Day 2 Adjustment ..	\$2,500	0	\$2,500
Day 3 Adjustment ..	(1,000)	0	(1,000)
Total .....	\$151,500	\$150,000	\$1,500
Net Tax Loss-Stocks 2 & 3 .....	0	(333)	333
Closing Balance .....	\$151,500	\$149,667	\$1,833

  

	Z		
	Book	Tax	Revaluation account
Opening Balance .....	\$152,500	\$152,500	0
Day 3 Adjustment ....	(1,000)	0	(\$1,000)
Total .....	\$151,500	\$152,500	(\$1,000)
Net Tax Loss-Stocks 2 & 3 .....	0	(1,333)	1,333
Closing Balance .....	\$151,500	\$151,167	\$333

(4) *Aggregation as permitted by the Commissioner.* The Commissioner may, by published guidance or by letter ruling, permit:

(i) Aggregation of properties other than those described in paragraphs (e)(2) and (e)(3) of this section;

(ii) Partnerships and partners not described in paragraph (e)(3) of this section to aggregate gain and loss from qualified financial assets; and

(iii) Aggregation of qualified financial assets for purposes of making section 704(c) allocations in the same manner as that described in paragraph (e)(3) of this section.

(f) *Effective date.* This section applies to property contributed to a partnership and to restatements pursuant to § 1.704-1(b)(2)(iv)(f) on or after December 21, 1993.

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#### § 1.704-4 Distribution of contributed property.

(a) *Determination of gain and loss—(1) In general.* A partner that contributes section 704(c) property to a partnership must recognize gain or loss under section 704(c)(1)(B) and this section on the distribution of such property to another partner within five years of its

contribution to the partnership in an amount equal to the gain or loss that would have been allocated to such partner under section 704(c)(1)(A) and § 1.704-3 if the distributed property had been sold by the partnership to the distributee partner for its fair market value at the time of the distribution. See § 1.704-3(a)(3)(i) for a definition of section 704(c) property.

(2) *Transactions to which section 704(c)(1)(B) applies.* Section 704(c)(1)(B) and this section apply only to the extent that a distribution by a partnership is a distribution to a partner acting in the capacity of a partner within the meaning of section 731.

(3) *Fair market value of property.* The fair market value of the distributed section 704(c) property is the price at which the property would change hands between a willing buyer and a willing seller at the time of the distribution, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. The fair market value that a partnership assigns to distributed section 704(c) property will be regarded as correct, provided that the value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests.

(4) *Determination of five-year period—*  
(i) *General rule.* The five-year period specified in paragraph (a)(1) of this section begins on and includes the date of contribution.

(ii) *Section 708(b)(1)(B) terminations.* A termination of the partnership under section 708(b)(1)(B) begins a new five-year period for each partner with respect to the built-in gain and built-in loss property that the partner is deemed to recontribute to a new partnership following the termination, but only to the extent that the pre-termination built-in gain or loss, if any, on such property would not have been allocated to the contributing partner under section 704(c)(1)(A) and § 1.704-3 on a sale of the contributed property to an unrelated party immediately before the termination. See § 1.704-3(a)(3)(ii) for the definitions of built-in gain and built-in loss on section 704(c) property.

(5) *Examples.* The following examples illustrate the rules of this paragraph

(a). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

*Example 1. Recognition of gain.* (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes \$10,000 cash and Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$4,000. Thus, there is a built-in gain of \$6,000 on Property A at the time of contribution. B contributes \$10,000 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$10,000. C contributes \$20,000 cash.

(ii) On December 31, 1998, Property A and Property B are distributed to C in complete liquidation of C's interest in the partnership.

(iii) A would have recognized \$6,000 of gain under section 704(c)(1)(A) and § 1.704-3 on the sale of Property A at the time of the distribution (\$10,000 fair market value less \$4,000 adjusted tax basis). As a result, A must recognize \$6,000 of gain on the distribution of Property A to C. B would not have recognized any gain or loss under section 704(c)(1)(A) and § 1.704-3 on the sale of Property B at the time of distribution because Property B was not section 704(c) property. As a result, B does not recognize any gain or loss on the distribution of Property B.

*Example 2. Effect of post-contribution depreciation deductions.* (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, depreciable property with a fair market value of \$30,000 and an adjusted tax basis of \$20,000. Therefore, there is a built-in gain of \$10,000 on Property A. B and C each contribute \$30,000 cash. ABC uses the traditional method of making section 704(c) allocations described in § 1.704-3(b) with respect to Property A.

(ii) Property A is depreciated using the straight-line method over its remaining 10-year recovery period. The partnership has book depreciation of \$3,000 per year (10 percent of the \$30,000 book basis), and each partner is allocated \$1,000 of book depreciation per year (one-third of the total annual book depreciation of \$3,000). The partnership has a tax depreciation deduction of \$2,000 per year (10 percent of the \$20,000 tax basis in Property A). This \$2,000 tax depreciation deduction is allocated equally between B and C, the noncontributing partners with respect to Property A.

(iii) At the end of the third year, the book value of Property A is \$21,000 (\$30,000 initial

book value less \$9,000 aggregate book depreciation) and the adjusted tax basis is \$14,000 (\$20,000 initial tax basis less \$6,000 aggregate tax depreciation). A's remaining section 704(c)(1)(A) built-in gain with respect to Property A is \$7,000 (\$21,000 book value less \$14,000 adjusted tax basis).

(iv) On December 31, 1997, Property A is distributed to B in complete liquidation of B's interest in the partnership. If Property A had been sold for its fair market value at the time of the distribution, A would have recognized \$7,000 of gain under section 704(c)(1)(A) and § 1.704-3(b). Therefore, A recognizes \$7,000 of gain on the distribution of Property A to B.

*Example 3. Effect of remedial method.* (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A1, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$5,000, and Property A2, nondepreciable real property with a fair market value and adjusted tax basis of \$10,000. B and C each contribute \$20,000 cash. ABC uses the remedial method of making section 704(c) allocations described in § 1.704-3(d) with respect to Property A1.

(ii) On December 31, 1998, when the fair market value of Property A1 has decreased to \$7,000, Property A1 is distributed to C in a current distribution. If Property A1 had been sold by the partnership at the time of the distribution, ABC would have recognized the \$2,000 of remaining built-in gain under section 704(c)(1)(A) on the sale (fair market value of \$7,000 less \$5,000 adjusted tax basis). All of this gain would have been allocated to A. ABC would also have recognized a book loss of \$3,000 (\$10,000 original book value less \$7,000 current fair market value of the property). Book loss in the amount of \$2,000 would have been allocated equally between B and C. Under the remedial method, \$2,000 of tax loss would also have been allocated equally to B and C to match their share of the book loss. As a result, \$2,000 of gain would also have been allocated to A as an offsetting remedial allocation. A would have recognized \$4,000 of total gain under section 704(c)(1)(A) on the sale of Property A1 (\$2,000 of section 704(c) recognized gain plus \$2,000 remedial gain). Therefore, A recognizes \$4,000 of gain on the distribution of Property A1 to C under this section.

(b) *Character of gain or loss—(1) General rule.* Gain or loss recognized by the contributing partner under section 704(c)(1)(B) and this section has the same character as the gain or loss that would have resulted if the distributed property had been sold by the partnership to the distributee partner at the time of the distribution.

(2) *Example.* The following example illustrates the rule of this paragraph (b). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

*Example. Character of gain.* (i) On January 1, 1995, A and B form partnership AB. A contributes \$10,000 and Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$4,000, in exchange for a 25 percent interest in partnership capital and profits. B contributes \$60,000 cash for a 75 percent interest in partnership capital and profits.

(ii) On December 31, 1998, Property A is distributed to B in a current distribution. Property A is used in a trade or business of B.

(iii) A would have recognized \$6,000 of gain under section 704(c)(1)(A) on a sale of Property A at the time of the distribution (the difference between the fair market value (\$10,000) and the adjusted tax basis (\$4,000) of the property at that time). Because Property A is not a capital asset in the hands of Partner B and B holds more than 50 percent of partnership capital and profits, the character of the gain on a sale of Property A to B would have been ordinary income under section 707(b)(2). Therefore, the character of the gain to A on the distribution of Property A to B is ordinary income.

(c) *Exceptions*—(1) *Property contributed on or before October 3, 1989.* Section 704(c)(1)(B) and this section do not apply to property contributed to the partnership on or before October 3, 1989.

(2) *Certain liquidations.* Section 704(c)(1)(B) and this section do not apply to a distribution of an interest in section 704(c) property to a partner other than the contributing partner in a liquidation of the partnership if—

(i) The contributing partner receives an interest in the section 704(c) property contributed by that partner (and no other property); and

(ii) The built-in gain or loss in the interest distributed to the contributing partner, determined immediately after the distribution, is equal to or greater than the built-in gain or loss on the property that would have been allocated to the contributing partner

under section 704(c)(1)(A) and § 1.704-3 on a sale of the contributed property to an unrelated party immediately before the distribution.

(3) *Section 708(b)(1)(B) termination.* Section 704(c)(1)(B) and this section do not apply to a deemed distribution of property caused by a termination of the partnership under section 708(b)(1)(B). See paragraph (a)(4)(ii) of this section for a special rule regarding a new five-year period for certain property deemed contributed to a new partnership following a termination of the partnership under section 708(b)(1)(B). See also § 1.737-2(a) for a similar rule in the context of section 737.

(4) *Complete transfer to another partnership.* Section 704(c)(1)(B) and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement. A subsequent distribution of section 704(c) property by the transferee partnership to a partner of the transferee partnership is subject to section 704(c)(1)(B) to the same extent that a distribution by the transferor partnership would have been subject to section 704(c)(1)(B). See § 1.737-2(b) for a similar rule in the context of section 737.

(5) *Incorporation of a partnership.* Section 704(c)(1)(B) and this section do not apply to an incorporation of a partnership by any method of incorporation (other than a method involving an actual distribution of partnership property to the partners followed by a contribution of that property to a corporation), provided that the partnership is liquidated as part of the incorporation transaction. See § 1.737-2(c) for a similar rule in the context of section 737.

(6) *Undivided interests.* Section 704(c)(1)(B) and this section do not apply to a distribution of an undivided interest in property to the extent that the undivided interest does not exceed the undivided interest, if any, contributed by the distributee partner in the same property. See § 1.737-2(d)(4) for the application of section 737 in a similar

context. The portion of the undivided interest in property retained by the partnership after the distribution, if any, that is treated as contributed by the distributee partner, is reduced to the extent of the undivided interest distributed to the distributee partner.

(7) *Example.* The following example illustrates the rule of paragraph (c)(2) of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

*Example.* (i) On January 1, 1995, A and B form partnership AB, as equal partners. A contributes Property A, nondepreciable real property with a fair market value and adjusted tax basis of \$20,000. B contributes Property B, nondepreciable real property with a fair market value of \$20,000 and an adjusted tax basis of \$10,000. Property B therefore has a built-in gain of \$10,000 at the time of contribution.

(ii) On December 31, 1998, the partnership liquidates when the fair market value of Property A has not changed, but the fair market value of Property B has increased to \$40,000.

(iii) In the liquidation, A receives Property A and a 25 percent interest in Property B. This interest in Property B has a fair market value of \$10,000 to A, reflecting the fact that A was entitled to 50 percent of the \$20,000 post-contribution appreciation in Property B. The partnership distributes to B a 75 percent interest in Property B with a fair market value of \$30,000. B's basis in this portion of Property B is \$10,000 under section 732(b). As a result, B has a built-in gain of \$20,000 in this portion of Property B immediately after the distribution (\$30,000 fair market value less \$10,000 adjusted tax basis). This built-in gain is greater than the \$10,000 of built-in gain in Property B at the time of contribution to the partnership. B therefore does not recognize any gain on the distribution of a portion of Property B to A under this section.

(d) *Special rules—(1) Nonrecognition transactions.* Property received by the partnership in exchange for section 704(c) property in a nonrecognition transaction is treated as the section 704(c) property for purposes of section 704(c)(1)(B) and this section to the extent that the property received is

treated as section 704(c) property under § 1.704-3(a)(8). See § 1.737-2(d)(3) for a similar rule in the context of section 737.

(2) *Transfers of a partnership interest.* The transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of section 704(c)(1)(B) and this section to the extent of the share of built-in gain or loss allocated to the transferee partner. See § 1.704-3(a)(7).

(3) *Distributions of like-kind property.* If section 704(c) property is distributed to a partner other than the contributing partner and like-kind property (within the meaning of section 1031) is distributed to the contributing partner no later than the earlier of (i) 180 days following the date of the distribution to the non-contributing partner, or (ii) the due date (determined with regard to extensions) of the contributing partner's income tax return for the taxable year of the distribution to the non-contributing partner, the amount of gain or loss, if any, that the contributing partner would otherwise have recognized under section 704(c)(1)(B) and this section is reduced by the amount of built-in gain or loss in the distributed like-kind property in the hands of the contributing partner immediately after the distribution. The contributing partner's basis in the distributed like-kind property is determined as if the like-kind property were distributed in an unrelated distribution prior to the distribution of any other property distributed as part of the same distribution and is determined without regard to the increase in the contributing partner's adjusted tax basis in the partnership interest under section 704(c)(1)(B) and this section. See § 1.707-3 for provisions treating the distribution of the like-kind property to the contributing partner as a disguised sale in certain situations.

(4) *Example.* The following example illustrates the rules of this paragraph (d). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the

partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

*Example. Distribution of like-kind property.*

(i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of \$20,000 and an adjusted tax basis of \$10,000. B and C each contribute \$20,000 cash. The partnership subsequently buys Property X, nondepreciable real property of a like-kind to Property A with a fair market value and adjusted tax basis of \$8,000. The fair market value of Property X subsequently increases to \$10,000.

(ii) On December 31, 1998, Property A is distributed to B in a current distribution. At the same time, Property X is distributed to A in a current distribution. The distribution of Property X does not result in the contribution of Property A being properly characterized as a disguised sale to the partnership under § 1.707-3. A's basis in Property X is \$8,000 under section 732(a)(1). A therefore has \$2,000 of built-in gain in Property X (\$10,000 fair market value less \$8,000 adjusted tax basis).

(iii) A would generally recognize \$10,000 of gain under section 704(c)(1)(B) on the distribution of Property A, the difference between the fair market value (\$20,000) of the property and its adjusted tax basis (\$10,000). This gain is reduced, however, by the amount of the built-in gain of Property X in the hands of A. As a result, A recognizes only \$8,000 of gain on the distribution of Property A to B under section 704(c)(1)(B) and this section.

(e) *Basis adjustments—(1) Contributing partner's basis in the partnership interest.* The basis of the contributing partner's interest in the partnership is increased by the amount of the gain, or decreased by the amount of the loss, recognized by the partner under section 704(c)(1)(B) and this section. This increase or decrease is taken into account in determining (i) the contributing partner's adjusted tax basis under section 732 for any property distributed to the partner in a distribution that is part of the same distribution as the distribution of the contributed property, other than like-kind property described in paragraph (d)(3) of this section (pertaining to the special rule for distributions of like-kind property), and (ii) the amount of the gain recognized by the contributing partner under section 731 or section 737, if any, on a distribution of money or property to the contributing partner that is part

of the same distribution as the distribution of the contributed property. For a determination of basis in a distribution subject to section 737, see § 1.737-3(a).

(2) *Partnership's basis in partnership property.* The partnership's adjusted tax basis in the distributed section 704(c) property is increased or decreased immediately before the distribution by the amount of gain or loss recognized by the contributing partner under section 704(c)(1)(B) and this section. Any increase or decrease in basis is therefore taken into account in determining the distributee partner's adjusted tax basis in the distributed property under section 732. For a determination of basis in a distribution subject to section 737, see § 1.737-3(b).

(3) *Section 754 adjustments.* The basis adjustments to partnership property made pursuant to paragraph (e)(2) of this section are not elective and must be made regardless of whether the partnership has an election in effect under section 754. Any adjustments to the bases of partnership property (including the distributed section 704(c) property) under section 734(b) pursuant to a section 754 election must be made after (and must take into account) the adjustments to basis made under paragraph (e)(2) of this section. See § 1.737-3(c)(4) for a similar rule in the context of section 737.

(4) *Example.* The following example illustrates the rules of this paragraph (e). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

*Example. Basis adjustment.* On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes \$10,000 cash and Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$4,000. B and C each contribute \$20,000 cash.

(ii) On December 31, 1998, Property A is distributed to B in a current distribution.

(iii) Under paragraph (a) of this section, A recognizes \$6,000 of gain on the distribution of Property A because that is the amount of

gain that would have been allocated to A under section 704(c)(1)(A) and § 1.704-3 on a sale of Property A for its fair market value at the time of the distribution (fair market value of Property A (\$10,000) less its adjusted tax basis at the time of distribution (\$4,000)). The adjusted tax basis of A's partnership interest is increased from \$14,000 to \$20,000 to reflect this gain. The partnership's adjusted tax basis in Property A is increased from \$4,000 to \$10,000 immediately prior to its distribution to B. B's adjusted tax basis in Property A is therefore \$10,000 under section 732(a)(1).

(f) *Anti-abuse rule*—(1) *In general.* The rules of section 704(c)(1)(B) and this section must be applied in a manner consistent with the purpose of section 704(c)(1)(B). Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 704(c)(1)(B), the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 704(c)(1)(B) and this section. Whether a tax result is inconsistent with the purpose of section 704(c)(1)(B) and this section must be determined based on all the facts and circumstances. See § 1.737-4 for an anti-abuse rule and examples in the context of section 737.

(2) *Examples.* The following examples illustrate the anti-abuse rule of this paragraph (f). The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

*Example 1. Distribution in substance made within five-year period; results inconsistent with the purpose of section 704(c)(1)(B).* (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Prop-

erty A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$1,000. B and C each contributes \$10,000 cash.

(ii) On December 31, 1998, the partners desire to distribute Property A to B in complete liquidation of B's interest in the partnership. If Property A were distributed at that time, however, A would recognize \$9,000 of gain under section 704(c)(1)(B), the difference between the \$10,000 fair market value and the \$1,000 adjusted tax basis of Property A, because Property A was contributed to the partnership less than five years before December 31, 1998. On becoming aware of this potential gain recognition, and with a principal purpose of avoiding such gain, the partners amend the partnership agreement on December 31, 1998, and take any other steps necessary to provide that substantially all of the economic risks and benefits of Property A are borne by B as of December 31, 1998, and that substantially all of the economic risks and benefits of all other partnership property are borne by A and C. The partnership holds Property A until January 5, 2000, at which time it is distributed to B in complete liquidation of B's interest in the partnership.

(iii) The actual distribution of Property A occurred more than five years after the contribution of the property to the partnership. The steps taken by the partnership on December 31, 1998, however, are the functional equivalent of an actual distribution of Property A to B in complete liquidation of B's interest in the partnership as of that date. Section 704(c)(1)(B) requires recognition of gain when contributed section 704(c) property is in substance distributed to another partner within five years of its contribution to the partnership. Allowing a contributing partner to avoid section 704(c)(1)(B) through arrangements such as those in this *Example 1* that have the effect of a distribution of property within five years of the date of its contribution to the partnership would effectively undermine the purpose of section 704(c)(1)(B) and this section. As a result, the steps taken by the partnership on December 31, 1998, are treated as causing a distribution of Property A to B for purposes of section 704(c)(1)(B) on that date, and A recognizes gain of \$9,000 under section 704(c)(1)(B) and this section at that time.

(iv) Alternatively, if on becoming aware of the potential gain recognition to A on a distribution of Property A on December 31, 1998, the partners had instead agreed that B would continue as a partner with no changes to the partnership agreement or to B's economic interest in partnership operations, the distribution of Property A to B on January 5, 2000, would not have been inconsistent with the purpose of section 704(c)(1)(B) and this section. In that situation, Property A would not have been distributed until after the expiration of the five-year period specified in



section 704(c)(1)(B) and this section. Deferring the distribution of Property A until the end of the five-year period for a principal purpose of avoiding the recognition of gain under section 704(c)(1)(B) and this section is not inconsistent with the purpose of section 704(c)(1)(B). Therefore, A would not have recognized gain on the distribution of Property A in that case.

*Example 2. Suspension of five-year period in manner consistent with the purpose of section 704(c)(1)(B).* (i) A, B, and C form partnership ABC on January 1, 1995, to conduct bona fide business activities. A contributes Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$1,000, in exchange for a 49.5 percent interest in partnership capital and profits. B contributes \$10,000 in cash for a 49.5 percent interest in partnership capital and profits. C contributes cash for a 1 percent interest in partnership capital and profits. A and B are wholly owned subsidiaries of the same affiliated group and continue to control the management of Property A by virtue of their controlling interests in the partnership. The partnership is formed pursuant to a plan a principal purpose of which is to minimize the period of time that A would have to remain a partner with a potential acquiror of Property A.

(ii) On December 31, 1997, D is admitted as a partner to the partnership in exchange for \$10,000 cash.

(iii) On January 5, 2000, Property A is distributed to D in complete liquidation of D's interest in the partnership.

(iv) The distribution of Property A to D occurred more than five years after the contribution of the property to the partnership. On these facts, however, a principal purpose of the transaction was to minimize the period of time that A would have to remain partners with a potential acquiror of Property A, and treating the five-year period of section 704(c)(1)(B) as running during a time when Property A was still effectively owned through the partnership by members of the contributing affiliated group of which A is a member is inconsistent with the purpose of section 704(c)(1)(B). Prior to the admission of D as a partner, the pooling of assets between A and B, on the one hand, and C, on the other hand, although sufficient to constitute ABC as a valid partnership for federal income tax purposes, is not a sufficient pooling of assets for purposes of running the five-year period with respect to the distribution of Property A to D. Allowing a contributing partner to avoid section 704(c)(1)(B) through arrangements such as those in this *Example 2* would have the effect of substantially nullifying the five-year requirement of section 704(c)(1)(B) and this section and elevating the form of the transaction over its substance. As a result, with respect to the distribution of Property A to D, the five-year

period of section 704(c)(1)(B) is tolled until the admission of D as a partner on December 31, 1997. Therefore, the distribution of Property A occurred before the end of the five-year period of section 704(c)(1)(B), and A recognizes gain of \$9,000 under section 704(c)(1)(B) on the distribution.

(g) *Effective date.* This section applies to distributions by a partnership to a partner on or after January 9, 1995.

[T.D. 8642, 60 FR 66730, Dec. 26, 1995]

#### **§ 1.705-1 Determination of basis of partner's interest.**

(a) *General rule.* (1) Section 705 and this section provide rules for determining the adjusted basis of a partner's interest in a partnership. A partner is required to determine the adjusted basis of his interest in a partnership only when necessary for the determination of his tax liability or that of any other person. The determination of the adjusted basis of a partnership interest is ordinarily made as of the end of a partnership taxable year. Thus, for example, such year-end determination is necessary in ascertaining the extent to which a partner's distributive share of partnership losses may be allowed. See section 704(d). However, where there has been a sale or exchange of all or a part of a partnership interest or a liquidation of a partner's entire interest in a partnership, the adjusted basis of the partner's interest should be determined as of the date of sale or exchange or liquidation. The adjusted basis of a partner's interest in a partnership is determined without regard to any amount shown in the partnership books as the partner's "capital", "equity", or similar account. For example, A contributes property with an adjusted basis to him of \$400 (and a value of \$1,000) to a partnership. B contributes \$1,000 cash. While under their agreement each may have a "capital account" in the partnership of \$1,000, the adjusted basis of A's interest is only \$400 and B's interest \$1,000.

(2) The original basis of a partner's interest in a partnership shall be determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests). Such basis shall be increased under section 722 by any further contributions to the partnership

and by the sum of the partner's distributive share for the taxable year and prior taxable years of:

(i) Taxable income of the partnership as determined under section 703(a),

(ii) Tax-exempt receipts of the partnership, and

(iii) The excess of the deductions for depletion over the basis of the depletable property, unless the property is an oil or gas property the basis of which has been allocated to partners under section 613A(c)(7)(D).

(3) The basis shall be decreased (but not below zero) by distributions from the partnership as provided in section 733 and by the sum of the partner's distributive share for the taxable year and prior taxable years of:

(i) Partnership losses (including capital losses), and

(ii) Partnership expenditures which are not deductible in computing partnership taxable income or loss and which are not capital expenditures.

(4) The basis shall be decreased (but not below zero) by the amount of the partner's deduction for depletion allowable under section 611 for any partnership oil and gas property to the extent the deduction does not exceed the proportionate share of the adjusted basis of the property allocated to the partner under section 613A(c)(7)(D).

(5) The basis shall be adjusted (but not below zero) to reflect any gain or loss to the partner resulting from a disposition by the partnership of a domestic oil or gas property after December 31, 1974.

(6) For the effect of liabilities in determining the amount of contributions made by a partner to a partnership or the amount of distributions made by a partnership to a partner, see section 752 and § 1.752-1, relating to the treatment of certain liabilities. In determining the basis of a partnership interest on the effective date of subchapter K, chapter 1 of the Code, or any of the sections thereof, the partner's share of partnership liabilities on that date shall be included.

(b) *Alternative rule.* In certain cases, the adjusted basis of a partner's interest in a partnership may be determined by reference to the partner's share of the adjusted basis of partnership property which would be distributable upon

termination of the partnership. The alternative rule may be used to determine the adjusted basis of a partner's interest where circumstances are such that the partner cannot practicably apply the general rule set forth in section 705(a) and paragraph (a) of this section, or where, from a consideration of all the facts, it is, in the opinion of the Commissioner, reasonable to conclude that the result produced will not vary substantially from the result obtainable under the general rule. Where the alternative rule is used, adjustments may be necessary in determining the adjusted basis of a partner's interest in a partnership. Adjustments would be required, for example, in order to reflect in a partner's share of the adjusted basis of partnership property any significant discrepancies arising as a result of contributed property, transfers of partnership interests, or distributions of property to the partners. The operation of the alternative rules may be illustrated by the following examples:

*Example 1.* The ABC partnership, in which A, B, and C are equal partners, owns various properties with a total adjusted basis of \$1,500 and has earned and retained an additional \$1,500. The total adjusted basis of partnership property is thus \$3,000. Each partner's share in the adjusted basis of partnership property is one-third of this amount, or \$1,000. Under the alternative rule, this amount represents each partner's adjusted basis for his partnership interest.

*Example 2.* Assume that partner A in example 1 of this paragraph sells his partnership interest to D for \$1,250 at a time when the partnership property with an adjusted basis of \$1,500 had appreciated in value to \$3,000, and when the partnership also had \$750 in cash. The total adjusted basis of all partnership property is \$2,250 and the value of such property is \$3,750. D's basis for his partnership interest is his cost, \$1,250. However, his one-third share of the adjusted basis of partnership property is only \$750. Therefore, for the purposes of the alternative rule, D has an adjustment of \$500 in determining the basis of his interest. This amount represents the difference between the cost of his partnership interest and his share of partnership basis at the time of his purchase. If the partnership subsequently earns and retains an additional \$1,500, its property will have an adjusted basis of \$3,750. D's adjusted basis for his interest under the alternative rule is \$1,750, determined by adding \$500, his basis adjustment to \$1,250 (his one-third share of

the \$3,750 adjusted basis of partnership property). If the partnership distributes \$250 to each partner in a current distribution, D's adjusted basis for his interest will be \$1,500 (\$1,000, his one-third share of the remaining basis of partnership property, \$3,000, plus his basis adjustment of \$500).

*Example 3.* Assume that BCD partnership in example 2 of this paragraph continues to operate. In 1960, D proposes to sell his partnership interest and wishes to evaluate the tax consequences of such sale. It is necessary, therefore, to determine the adjusted basis of his interest in the partnership. Assume further that D cannot determine the adjusted basis of his interest under the general rule. The balance sheet of the BCD partnership is as follows:

Assets	Adjusted basis per books	Market value
Cash .....	\$3,000	\$3,000
Receivables .....	4,000	4,000
Depreciable property .....	5,000	5,000
Land held for investment .....	18,000	30,000
<b>Total .....</b>	<b>30,000</b>	<b>42,000</b>
Liabilities and capital		Per books
Liabilities .....		\$6,000
Capital accounts:		
B .....		4,500
C .....		4,500
D .....		15,000
<b>Total .....</b>		<b>30,000</b>

The \$15,000 representing the amount of D's capital account does not reflect the \$500 basis adjustment arising from D's purchase of his interest. See example 2 of this paragraph. The adjusted basis of D's partnership interest determined under the alternative rule is as follows:

D's share of the adjusted basis of partnership property (reduced by the amount of liabilities) at time of proposed sale .....	\$15,000
D's share of partnership liabilities (under the partnership agreement liabilities are shared equally) .....	2,000
D's basis adjustment from example 2 .....	500
<b>Adjusted basis of D's interest at the time of proposed sale, as determined under alternative rule .....</b>	<b>17,500</b>

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8437, 57 FR 43903, Sept. 23, 1992]

### § 1.706-1 Taxable years of partner and partnership.

(a) *Year in which partnership income is includible.* (1) In computing his taxable income for a taxable year, a partner is required to include his distributive

share of partnership items set forth in section 702 for any partnership year ending within or with his taxable year. A partner shall also include in his taxable income for a taxable year "guaranteed payments" under section 707(c) which are made to him in a partnership taxable year ending within or with his taxable year. The provisions of this subparagraph may be illustrated by the following example:

*Example.* Partner A reports his income for a calendar year, while the partnership of which he is a member reports its income for a fiscal year ending May 31. During the partnership taxable year ending May 31, 1956, A received guaranteed payments of \$1,200 for services and for the use of capital. Of this amount, \$700 was received by A between June 1 and December 31, 1955, and the remaining \$500 was received by him between January 1 and May 31, 1956. This entire \$1,200 received by A is includible in his taxable income for the calendar year 1956 (together with his distributive share of partnership items set forth in section 702 for the partnership taxable year ending May 31, 1956).

(2) If a partner receives distributions under section 731 or sells or exchanges all or part of his partnership interest, any gain or loss arising therefrom does not constitute partnership income and is includible in the partner's gross income for his taxable year in which the payment is made. See sections 451 and 461.

(b) *Adoption or change in taxable year.*—(1) *Partnership taxable year.* (i) The taxable year of a partnership shall be determined as though the partnership were a taxpayer.

(ii) A newly formed partnership may adopt a taxable year which is the same as the taxable year of all its principal partners (or the same as the taxable year to which all of its principal partners are concurrently changing) without securing prior approval from the Commissioner, or it may adopt a calendar year without securing prior approval from the Commissioner if all its principal partners are not on the same taxable year. In any other case, a newly formed partnership must secure prior approval from the Commissioner for the adoption of a taxable year.

(iii) An existing partnership may not change its taxable year without securing prior approval from the Commissioner, unless all its principal partners

have the same taxable year to which the partnership changes, or unless all its principal partners concurrently change to such taxable year.

(2) *Partner's taxable year.* A partner may not change his taxable year without securing prior approval from the Commissioner. See section 442 and the regulations thereunder.

(3) *Principal partner.* For the purpose of this paragraph, a principal partner is a partner having an interest of 5 percent or more in partnership profits or capital.

(4) *Application for approval—(i) Change.* Application for a change in a taxable year shall be filed on Form 1128 with the Commissioner of Internal Revenue, Washington, DC 20224. If the short period involved in the change ends after December 31, 1973, such form shall be filed on or before the 15th day of the second calendar month following the close of such short period; if such short period ends before January 1, 1974, such form shall be filed on or before the last day of the first calendar month following the close of such short period.

(ii) *Adoption.* Where a newly formed partnership is required to secure prior approval from the Commissioner for the adoption of a taxable year, the partnership shall file an application on Form 1128 with the Commissioner on or before the last day of the month following the close of the taxable year to be adopted. The partnership shall modify Form 1128 to the extent necessary to indicate that it is an application for adoption of a taxable year.

(iii) *Business purpose.* Where prior approval is required under this paragraph, the applicant must establish a business purpose to the satisfaction of the Commissioner. For example, partnership AB, which is on a calendar year, is engaged in a business which has a natural business year (the annual accounting period encompassing all related income and expenses) ending on September 30th. The intention of the partnership to make its tax year coincide with such natural business year constitutes a sufficient business purpose.

(5) *Returns—(i) Partner.* A partner who changes his taxable year shall make his return for a short period in

accordance with section 443, and shall attach to the return a copy of the letter from the Commissioner granting approval for the change of taxable year.

(ii) *Partnership.* (a) A partnership which changes its taxable year shall make its return for a short period in accordance with section 443, but shall not annualize the partnership taxable income. The partnership shall attach to the return either a copy of the letter from the Commissioner granting approval of the change of taxable year, or a statement indicating that the partnership is changing its taxable year to the same taxable year as that of all its principal partners or to the same taxable year as that to which all its principal partners are concurrently changing.

(b) Any newly formed partnership shall file with its first return either:

(1) A copy of the letter from the Commissioner approving the adoption of a partnership taxable year which is not the same as the taxable year of all its principal partners; or

(2) A statement indicating that the taxable year it has adopted is the same as the taxable year of all its principal partners, or that all its principal partners are concurrently changing to the taxable year it has adopted; or

(3) A statement that all its principal partners are not on the same taxable year and that it is adopting a calendar year without prior approval.

(6) *Effective date.* Section 706(b) applies to any partnership which adopts or changes to a taxable year beginning on or after April 2, 1954, and to any partner who changes to a taxable year beginning on or after that date. For the purpose of applying this provision, section 708 (relating to the continuation of a partnership) applies to any such taxable year. See section 771(b)(1) and paragraph (b)(1) of § 1.771-1. If a partnership has changed to or adopted, or if a partner has changed to, a taxable year beginning on or after April 2, 1954, without obtaining prior approval of the Commissioner, and if, under the provisions of this paragraph, prior approval is required for the change or adoption, such annual accounting period will not be accepted as a taxable year until approval thereof is secured.

Under these circumstances, an application to change to or adopt the desired taxable year will be considered timely if filed before August 23, 1956.

(7) *Cross-reference to § 1.442-2T and § 1.442-3T.* For special rules applicable to certain changes in annual accounting period where the short period involved in the change ends in 1986 or 1987, see § 1.442-2T. For special rules applicable to certain adoptions and retentions of a taxable year ending in 1986 or 1987, see § 1.442-3T.

(c) *Closing of partnership year*—(1) *General rule.* Section 706(c) and this paragraph provide rules governing the closing of partnership years. The closing of a partnership taxable year or a termination of a partnership for Federal income tax purposes is not necessarily governed by the “dissolution”, “liquidation”, etc., of a partnership under State or local law. The taxable year of a partnership shall not close as the result of the death of a partner, the entry of a new partner, the liquidation of a partner's entire interest in the partnership (as defined in section 761(d)), or the sale or exchange of a partner's interest in the partnership, except in the case of a termination of a partnership and except as provided in subparagraph (2) of this paragraph. In the case of termination, the partnership taxable year closes for all partners as of the date of termination. See section 708(b) and paragraph (b) of § 1.708-1.

(2) *Partner who retires or sells interest in partnership*—(i) *Disposition of entire interest.* A partnership taxable year shall close with respect to a partner who sells or exchanges his entire interest in a partnership, and with respect to a partner whose entire interest is liquidated. However, a partnership taxable year with respect to a partner who dies shall not close prior to the end of such partnership taxable year, or the time when such partner's interest (held by his estate or other successor) is liquidated or sold or exchanged, whichever is earlier. See subparagraph (3) of this paragraph.

(ii) *Inclusions in taxable income.* In the case of a sale, exchange, or liquidation of a partner's entire interest in a partnership, the partner shall include in his taxable income for his taxable year

within or with which his membership in the partnership ends, his distributive share of items described in section 702(a), and any guaranteed payments under section 707(c), for his partnership taxable year ending with the date of such sale, exchange, or liquidation. In order to avoid an interim closing of the partnership books, such partner's distributive share of items described in section 702(a) may, by agreement among the partners, be estimated by taking his pro rata part of the amount of such items he would have included in his taxable income had he remained a partner until the end of the partnership taxable year. The proration may be based on the portion of the taxable year that has elapsed prior to the sale, exchange, or liquidation, or may be determined under any other method that is reasonable. Any partner who is the transferee of such partner's interest shall include in his taxable income, as his distributive share of items described in section 702(a) with respect to the acquired interest, the pro rata part (determined by the method used by the transferor partner) of the amount of such items he would have included had he been a partner from the beginning of the taxable year of the partnership. The application of this subdivision may be illustrated by the following example:

*Example.* Assume that a partner selling his partnership interest on June 30, 1955, has an adjusted basis for his interest of \$5,000 on that date; that his pro rata share of partnership income up to June 30 is \$15,000; and that he sells his interest for \$20,000. Under the provisions of section 706(c)(2), the partnership year with respect to him closes at the time of the sale. The \$15,000 is includible in his income as his distributive share and, under section 705, it increases the basis of his partnership interest to \$20,000, which is also the selling price of his interest. Therefore, no gain is realized on the sale of his partnership interest. The purchaser of this partnership interest shall include in his income as his distributive share his pro rata part of partnership income for the remainder of the partnership taxable year.

(3) *Partner who dies.* (i) When a partner dies, the partnership taxable year shall not close with respect to such partner prior to the end of the partnership taxable year. The partnership taxable year shall continue both for the

remaining partners and the decedent partner. Where the death of a partner results in the termination of the partnership, the partnership taxable year shall close for all partners on the date of such termination under section 708(b)(1)(A). See also paragraph (b)(1)(i)(b) of § 1.708-1 for the continuation of a 2-member partnership under certain circumstances after the death of a partner. However, if the decedent partner's estate or other successor sells or exchanges its entire interest in the partnership, or if its entire interest is liquidated, the partnership taxable year with respect to the estate or other successor in interest shall close on the date of such sale or exchange, or the date of completion of the liquidation.

(ii) The last return of a decedent partner shall include only his share of partnership taxable income for any partnership taxable year or years ending within or with the last taxable year for such decedent partner (i. e., the year ending with the date of his death). The distributive share of partnership taxable income for a partnership taxable year ending after the decedent's last taxable year is includible in the return of his estate or other successor in interest. If the estate or other successor in interest of a partner continues to share in the profits or losses of the partnership business, the distributives share thereof is includible in the taxable year of the estate or other successor in interest within or with which the taxable year of the partnership ends. See also paragraph (a)(1)(ii) of § 1.736-1. Where the estate or other successor in interest receives distributions, any gain or loss on such distributions is includible in its gross income for its taxable year in which the distribution is made.

(iii) If a partner (or a retiring partner), in accordance with the terms of the partnership agreement, designates a person to succeed to his interest in the partnership after his death, such designated person shall be regarded as a successor in interest of the deceased for purposes of this chapter. Thus, where a partner designates his widow as the successor in interest, her distributive share of income for the taxable year of the partnership ending within or with her taxable year may be

included in a joint return in accordance with the provisions of sections 2 and 6013(a) (2) and (3).

(iv) If, under the terms of an agreement existing at the date of death of a partner, a sale or exchange of the decedent partner's interest in the partnership occurs upon that date, then the taxable year of the partnership with respect to such decedent partner shall close upon the date of death. See section 706(c)(2)(A)(i). The sale or exchange of a partnership interest does not, for the purpose of this rule, include any transfer of a partnership interest which occurs at death as a result of inheritance or any testamentary disposition.

(v) To the extent that any part of a distributive share of partnership income of the estate or other successor in interest of a deceased partner is attributable to the decedent for the period ending with the date of his death, such part of the distributive share is income in respect of the decedent under section 691. See section 691 and the regulations thereunder.

(vi) The provisions of this subparagraph may be illustrated by the following examples:

*Example 1.* B has a taxable year ending December 31 and is a member of partnership ABC, the taxable year of which ends on June 30. B dies on October 31, 1955. His estate (which as a new taxpayer may, under section 441 and the regulations thereunder, adopt any taxable year) adopts a taxable year ending October 31. The return of the decedent for the period January 1 to October 31, 1955, will include only his distributive share of taxable income of the partnership for its taxable year ending June 30, 1955. The distributive share of taxable income of the partnership for its taxable year ending June 30, 1956, arising from the interest of the decedent, will be includible in the return of the estate for its taxable year ending October 31, 1956. That part of the distributive share attributable to the decedent for the period ending with the date of his death (July 1 through October 31, 1955) is income in respect of a decedent under section 691.

*Example 2.* Assume the same facts as in example 1 of this subdivision, except that, prior to B's death, B and D had agreed that, upon B's death, D would purchase B's interest for \$10,000. When B dies on October 31, 1955, the partnership taxable year beginning July 1, 1955, closes with respect to him. Therefore, the return for B's last taxable

year (January 1 to October 31, 1955) will include his distributive share of taxable income of the partnership for its taxable year ending June 30, 1955, plus his distributive share of partnership taxable income for the period July 1 to October 31, 1955. See subdivision (iv) of this subparagraph.

*Example 3.* H is a member of a partnership having a taxable year ending December 31. Both H and his wife W are on a calendar year and file joint returns. H dies on March 31, 1955. Administration of the estate is completed and the estate, including the partnership interest, is distributed to W as legatee on November 30, 1955. Such distribution by the estate is not a sale or exchange of H's partnership interest. No part of the taxable income of the partnership for the taxable year ending December 31, 1955, which is allocable to H, will be included in H's taxable income for his last taxable year (January 1 through March 31, 1955) or in the taxable income of H's estate for the taxable year April 1 through November 30, 1955. The distributive share of partnership taxable income for the full calendar year that is allocable to H will be includible in the taxable income of W for her taxable year ending December 31, 1955, and she may file a joint return under sections 2 and 6013(a)(3). That part of the distributive share attributable to the decedent for the period ending with the date of his death (January 1 through March 31, 1955) is income in respect of a decedent under section 691.

*Example 4.* M is a member of partnership JKM which operates on a calendar year. M and his wife S file joint returns for calendar years. In accordance with the partnership agreement, M designated S to succeed to his interest in the partnership upon his death. M, who had withdrawn \$10,000 from the partnership before his death, dies on October 20, 1955. S's distributive share of income for the taxable year 1955 is \$15,000 (\$10,000 of which represents the amount withdrawn by M). S shall include \$15,000 in her income, even though M received \$10,000 of this amount before his death. S may file a joint return with M for the year 1955 under sections 2 and 6013(a). That part of the \$15,000 distributive share attributable to the decedent for the period ending with the date of his death (January 1 through October 20, 1955) is income in respect of a decedent under section 691.

(4) *Disposition of less than entire interest.* If a partner sells or exchanges a part of his interest in a partnership, or if the interest of a partner is reduced, the partnership taxable year shall continue to its normal end. In such case, the partner's distributive share of items which he is required to include in his taxable income under the provisions of section 702(a) shall be deter-

mined by taking into account his varying interests in the partnership during the partnership taxable year in which such sale, exchange, or reduction of interest occurred.

(5) *Transfer of interest by gift.* The transfer of a partnership interest by gift does not close the partnership taxable year with respect to the donor. However, the income up to the date of gift attributable to the donor's interest shall be allocated to him under section 704(e)(2).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7286, 38 FR 26912, Sept. 27, 1973; T.D. 8123, 52 FR 3623, Feb. 5, 1987]

#### **§ 1.706-1T Taxable years of certain partnerships (temporary).**

(a) *Taxable year determined by reference to the partners—(1) In general.* If for any taxable year a partnership's taxable year cannot be determined by reference to the taxable year of its partners owning a majority interest in partnership profits and capital (as described in section 706(b)(1)(B)(i)) or by reference to the taxable year of all its principal partners (as described in section 706(b)(1)(B)(ii)), then the partnership must determine its taxable year under section 706(b)(1)(B)(iii). Under section 706(b)(1)(B)(iii), the taxable year of the partnership, except as provided in paragraph (b) of this section, shall be the taxable year that results in the least aggregate deferral of income to the partners (as determined under paragraph (a)(2) of this section). See § 1.706-3T(a) for special rules which provide that certain tax-exempt partners are disregarded.

(2) *Taxable year that results in the least aggregate deferral of income.* The taxable year that results in the least aggregate deferral of income will be the taxable year of one or more of the partners in the partnership which will result in the least aggregate deferral of income to the partners. The aggregate deferral for a particular year is equal to the sum of the products determined by multiplying the month(s) of deferral for each partner that would be generated by that year and each partner's interest in partnership profits for that year. The partner's taxable year that

produces the lowest sum when compared to the other partner's taxable years is the taxable year that results in the least aggregate deferral of income to the partners. If the calculation results in more than one taxable year qualifying as the taxable year with the least aggregate deferral, the partnership may select any one of those taxable years as its taxable year. However, if one of the qualifying taxable years is also the partnership's existing taxable year, the partnership must maintain its existing taxable year. The determination of the taxable year that results in the least aggregate deferral of income shall generally be made as of the beginning of the partnership's current taxable year. The district director, however, may determine that the first day of the current taxable year is not the appropriate testing day and require the use of some other day or period that will more accurately reflect the ownership of the partnership and thereby the actual aggregate deferral to the partners where the partners engage in a transaction that has as its principal purpose the avoidance of the principles of this section. Thus, for example the preceding sentence would apply where there is a transfer of an interest in the partnership that results in a temporary transfer of that interest principally for purposes of qualifying for a specific taxable year under the principles of this section. For purposes of this section, deferral to each partner is measured in terms of months from the end of the partnership's taxable year forward to the end of the partner's taxable year.

(3) *Determination of the taxable year of a partner or partnership that uses a 52-53 week taxable year.* For purposes of the calculation described in paragraph (a)(2) of this section, the taxable year of a partner or partnership that uses a 52-53 week taxable year shall be the same year determined under the rules of section 441(f) and the regulations thereunder with respect to the inclusion of income by the partner or partnership.

(4) *Special de minimis rule.* If the taxable year that results in the least aggregate deferral produces an aggregate deferral that is less than .5 when compared to the aggregate deferral of the

current taxable year, the partnership's current taxable year shall be treated as the taxable year with the least aggregate deferral. Thus, the partnership will not be permitted to change its taxable year. However, this de minimis rule will not apply to the first taxable period beginning after December 31, 1986.

(b) *Business purpose.* A partnership may have a taxable year other than the year described in paragraph (a) of this section if it establishes, to the satisfaction of the Commissioner of Internal Revenue, a business purpose for such taxable year in accordance with and under the procedures established in § 1.442-1(b)(1). For purposes of this paragraph (b), any deferral of income to partners shall not be treated as a business purpose.

(c) *Procedural requirements and effective date—*(1) *In general.* The change in accounting period required by paragraph (a) of this section shall be treated as initiated by the partnership and made with the consent of the Commissioner. To effect the change, a partnership must show that the requirements of this section are satisfied in a statement setting forth the computations required to establish the taxable year that results in the least aggregate deferral of income to the partners under paragraph (a) of this section. The partnership must attach the statement to the income tax return for the short period involved in the changes and must indicate the following at the top of page 1 of the return: "FILED UNDER § 1.706-1T."

(2) *Effective date—*(i) *In general.* Except as provided in paragraph (c)(2)(ii) of this section, the rules of this section are effective for partnership taxable years beginning after December 31, 1986.

(ii) *Special rule for first taxable year beginning after December 31, 1986.* A partnership otherwise required to change its accounting period for its first taxable year beginning after December 31, 1986 to a year resulting in the least aggregate deferral of income to its partners under paragraph (a) of this section, may, at its option, delay the application of the rules of that paragraph until its first taxable year beginning after December 31, 1987. In such a case,



the partnership must conform its first taxable year beginning after December 31, 1986 to the calendar year and must apply the rules of paragraph (a) of this section to its first taxable year beginning after December 31, 1987. See § 1.702-3T(a)(1) regarding the availability of a 4-year spread provision with respect to a partnership required to change its taxable year for its first taxable year beginning after December 31, 1986.

(iii) *Special eligibility for 4-year spread; years beginning after December 31, 1987.* Notwithstanding the provisions of § 1.702-3T(a)(1) limiting the availability of the 4-year spread provisions to a partnership's first taxable year beginning after December 31, 1986, if—

(A) A partnership is required under section 706(b)(1)(B)(iii) and paragraph (a) of this section to change to a taxable year that results in the least aggregate deferral of income to the partners for a partnership's first taxable year beginning after December 31, 1987,

(B) The partnership did exercise its option, as provided in paragraph (c)(2)(ii) of this section, to delay the application of the rules of paragraph (a) of this section until the partnership's first taxable year beginning after December 31, 1987, and

(C) The partnership would have been required to change its accounting period under section 706(b)(1)(B)(iii) and paragraph (a) of this section for its first taxable year beginning after December 31, 1986, if paragraph (a) of this section had been applicable to such taxable year, the partners in the partnership will be eligible to utilize the 4-year spread provision provided in § 1.702-3T (subject to the other requirements of that section) with respect to the partnership's change in accounting period required under section 706(b)(1)(B)(iii) and paragraph (a) of this section for the partnership's first taxable year beginning after December 31, 1987.

(d) *Examples.* The principles of this section may be illustrated by the following examples:

*Example 1.* Partnership P is on a fiscal year ending June 30. Partner A reports income on the fiscal year ending June 30 and Partner B reports income on the fiscal year ending July 31. A and B each have a 50 percent inter-

est in partnership profits. For its taxable year beginning July 1, 1987, the partnership will be required to retain its taxable year since the fiscal year ending June 30 results in the least aggregate deferral of income to the partners. This determination is made as follows:

Test 6/30	Year End	Interest in Partnership Profits	Months of Deferral for 6/30 Year End	Interest x Deferral
Partner A .....	6/30	.5	0	0
Partner B .....	7/31	.5	1	.5
Aggregate deferral .....				.5

Test 7/31	Year End	Interest in Partnership Profits	Months of Deferral for 7/31 Year End	Interest x Deferral
Partner A .....	6/30	.5	11	5.5
Partner B .....	7/31	.5	0	0
Aggregate deferral .....				5.5

*Example 2.* The facts are the same as in *Example 1* except that A reports income on the calendar year and B reports on the fiscal year ending November 30. For the partnership's taxable year beginning July 1, 1987, the partnership is required to change its taxable year to a fiscal year ending November 30 because such year results in the least aggregate deferral of income to the partners. This determination is made as follows:

Test 12/31	Year End	Interest in Partnership Profits	Months of Deferral for 12/31 Year End	Interest x Deferral
Partner A .....	12/31	.5	0	0
Partner B .....	11/30	.5	11	5.5
Aggregate deferral .....				5.5

Test 11/30	Year End	Interest in Partnership Profits	Months of Deferral for 11/30 Year End	Interest x Deferral
Partner A .....	12/31	.5	1	.5
Partner B .....	11/30	.5	0	0
Aggregate deferral .....				.5

*Example 3.* The facts are the same as in *Example 2* except that B reports income on the fiscal year ending June 30. For the partnership's taxable year beginning July 1, 1987, each partner's taxable year will result in identical aggregate deferral of income. If the partnership's current taxable year was neither a fiscal year ending June 30 nor the calendar year, the partnership would select either the fiscal year ending June 30 or the calendar year as its taxable year. However, since the partnership's current taxable year

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ends June 30, it must retain its current taxable year.

Test 12/31	Year End	Interest in Partnership Profits	Months of Deferral for 12/31 Year End	Interest x Deferral
Partner A .....	12/31	.5	0	0
Partner B .....	6/30	.5	6	3.0
Aggregate deferral .....				3.0

  

Test 6/30	Year End	Interest in Partnership Profits	Months of Deferral for 6/30 Year End	Interest x Deferral
Partner A .....	12/31	.5	6	3.0
Partner B .....	6/30	.5	0	0
Aggregate deferral .....				3.0

**Example 4.** The facts are the same as in *Example 1* except that on December 31, 1987, partner A sells a 4 percent interest in the partnership to Partner C, who reports income on the fiscal year ending June 30, and a 40 percent interest in the partnership to Partner D, who also reports income on the fiscal year ending June 30. The taxable year beginning July 1, 1987, is unaffected by the sale. However, for the taxable year beginning July 31, 1988, the partnership must determine the taxable year resulting in the least aggregate deferral as of July 1, 1988. In this case, the partnership will be required to retain its taxable year since the fiscal year ending June 30 continues to be the taxable year that results in the least aggregate deferral of income to the partners.

**Example 5.** The facts are the same as in *Example 4* except that Partner D reports income on the fiscal year ending April 30. As in *Example 4*, the taxable year during which the sale took place is unaffected by the shifts in interests. However, for its taxable year beginning July 1, 1988, the partnership will be required to change its taxable year to the fiscal year ending April 30. This determination is made as follows:

Test 7/31	Year End	Interest in Partnership Profits	Months of Deferral for 7/31 Year End	Interest x Deferral
Partner A .....	6/30	.06	11	.66
Partner B .....	7/31	.5	0	0
Partner C .....	6/30	.04	11	.44
Partner D .....	4/30	.4	9	3.60
Aggregate deferral .....				4.70

  

Test 6/30	Year End	Interest in Partnership Profits	Months of Deferral for 6/30 Year End	Interest x Deferral
Partner A .....	6/30	.06	0	0
Partner B .....	7/31	.5	1	.5
Partner C .....	6/30	.04	0	0

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Test 6/30	Year End	Interest in Partnership Profits	Months of Deferral for 6/30 Year End	Interest x Deferral
Partner D .....	4/30	.4	10	4.0
Aggregate deferral .....				4.5

  

Test 4/30	Year End	Interest in Partnership Profits	Months of Deferral for 4/30 Year End	Interest x Deferral
Partner A .....	6/30	.06	2	.12
Partner B .....	7/31	.5	3	1.50
Partner C .....	6/30	.04	2	.08
Partner D .....	4/30	.4	0	0
Aggregate deferral .....				1.70

## § 1.706-1T(a)(4) Test:

Current taxable year (June 30) .....	4.5
Less: Taxable year producing the least aggregate deferral (April 30) .....	1.7
Additional aggregate deferral (greater than .5) .....	2.8

**Example 6.** Partnership P has two partners, A who reports income on the fiscal year ending March 31, and B who reports income on the fiscal year ending July 31. A and B share profits equally. P has determined its taxable year under § 1.706-1T(a)(2) to be the fiscal year ending March 31 as follows:

Test 3/31	Year End	Interest in Partnership Profits	Deferral for 3/31 Year End	Interest x Deferral
Partner A .....	3/31	.5	0	0
Partner B .....	7/31	.5	4	2
Aggregate deferral .....				2

  

Test 7/31	Year End	Interest in Partnership Profits	Deferral for 7/31 Year End	Interest x Deferral
Partner A .....	3/31	.5	8	4
Partner B .....	7/31	.5	0	0
Aggregate deferral .....				4

In May 1988, Partner A sells a 45 percent interest in the partnership to C, who reports income on the fiscal year ending April 30. For the taxable period beginning April 1, 1989, the fiscal year ending April 30 is the taxable year that produces the least aggregate deferral of income to the partners. However, under paragraph (a)(4) of this section the partnership is required to retain its fiscal year ending March 31. This determination is made as follows:

Test 3/31	Year End	Interest in Partnership Profits	Deferral for 3/31 Year End	Interest x Deferral
Partner A .....	3/31	.05	0	0
Partner B .....	7/31	.5	4	2.0